SUPREME COURT, U.S.
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No. 92-1069

In the Supreme Court of the United States

OCTOBER TERM, 1992

KERRY W. ILLES, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether petitioner was entitled to deduct as losses on transactions entered into for profit under Section 165(c) (2) of the Internal Revenue Code (26 U.S.C.) his out-of-pocket expenditures on master cassette recording transactions that admittedly lacked economic substance.

2. Whether petitioner was liable for the additions to tax for negligence and a substantial understatement of tax under Sections 6653(a) and 6661 of the Internal Revenue Code, as well as the increased rate of interest on an underpayment attributable to a tax motivated transaction under Section 6621(c), where he made no investigation of the venture or its promoter and sought no independent advice on the investment or its proper tax treatment.

3. Whether petitioner was liable for the addition to tax for a valuation overstatement under Section 6659 of the Internal Revenue Code, where his claimed deductions were disallowed on the ground that the transactions generating the deductions lacked economic substance.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-8a) is not yet reported. The memorandum opinion of the Tax Court (Pet. App. 13a-27a) is reported at 62 T.C.M. (CCH) 728.

JURISDICTION

The judgment of the court of appeals was entered on September 21, 1992. The petition for a writ of certiorari was filed on December 21, 1992 (a Monday). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. In 1985, Thomas Graham solicited petitioner to participate in a master recording promotion entitled Children's Classics Audio Cassettes (CCAC) (Pet. App. 1a-2a). Petitioner agreed to invest in two CCAC master recording transactions in 1985 (*id.* at 2a, 18a-19a). From his aggregate cash outlay of $33,175, he expected to receive tax deductions totaling $144,400 and an investment tax credit of $6,000 (*id.* at 19a). The CCAC transactions were structured so that his expenditures would be paid by the potential tax savings (*id.* at 22a). Petitioner had no background in the record or cassette business. He made no effort to consult with anyone in the industry, to obtain appraisals or in any other manner to determine whether the venture had substance or commercial viability. He relied solely on information from the promoter (Graham) that identified the substantial tax benefits involved. Petitioner executed the CCAC documents without reviewing them (*id.* at 19a, 22a.).

On Graham's advice, petitioner claimed deductions totaling $61,775 and an investment tax credit of $5,473 with respect to his CCAC transactions on his 1985 return (Pet. App. 2a-3a). The Commissioner determined that petitioner was not entitled to the deductions and the credit because the CCAC transactions lacked economic substance. The Commissioner also determined additions to tax for negligence under Section 6653(a) of the Internal Revenue Code (26 U.S.C.), for a valuation overstatement under Section 6659, and for a substantial understatement of tax under Section 6661, as well as liability for the increased interest on an underpayment attributable to a tax motivated transaction pursuant to Section 6621(c) (Pet. App. 3a, 23a-27a).

2. Petitioner sought a redetermination of the deficiency and additions in the Tax Court. Petitioner

stipulated that his CCAC transactions lacked economic substance, that the CCAC assets were overvalued on his tax return by more than 250%, and that he was not entitled to the credits and deductions that he had claimed (Pet. App. 3a, 20a, 27a). He nevertheless asserted that he was entitled to deduct his out-of-pocket CCAC expenditures under Section 165(c)(2) as losses on a transaction entered into for profit (Pet. App. 3a, 20a).

The Tax Court rejected petitioner's argument, finding that he "had no profit motive other than for the tax benefits" (Pet. App. 22a). The court also held that, even if petitioner had a profit motive, he "could not prevail in this case because the transactions lacked economic substance" (*ibid.*).

The Tax Court also upheld the additions to tax determined by the Commissioner. The court found petitioner liable for negligence under Section 6653(a)[1] because there was no evidence of Graham's experience in the recording or cassette industries, or his knowledge of investment and tax matters (Pet. App. 24a-25a). Further, petitioner had made no attempt to verify Graham's credentials in either area (*ibid.*). The court concluded that "reasonable caution dictates that further inquiry be made to verify the accuracy of the tax and investment information received" and that petitioner would have sought independent advice "if he were truly concerned

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[1] Section 6653(a)(1) imposed an addition to tax equal to five percent of an underpayment if any part of the underpayment was due to negligence or disregard of rules or regulations. Section 6653(a)(2) imposed an addition to tax equal to 50% of the interest payable under Section 6601 on the portion of the underpayment attributable to negligence. 26 U.S.C. 6653(a)(2) (1982). Section 6653 was repealed by the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7721(c)(1), 103 Stat. 2399. Provisions similar to Section 6653(a) are now found in Section 6662. See 26 U.S.C. 6662(b)(1) and (c) (Supp. II 1990).

about his investments, other than for the tax benefits" (*ibid.*).

In addition, the Tax Court concluded that petitioner was liable for the Section 6659 addition to tax due to his overstatement of the basis of the CCAC assets (Pet. App. 26a).[2] The court's determination that the CCAC transactions lacked economic substance included a finding that the CCAC property was overvalued (*id.* at 25a). The court concluded that petitioner's correct adjusted basis in the property was zero (*ibid.*). Because petitioner failed to show that he acted reasonably and in good faith in claiming the CCAC-related deductions, the Tax Court also rejected petitioner's argument that the Commissioner should have waived the substantial understatement penalty under Section 6661 (Pet. App. 26a).[3] Finally,

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[2] Section 6659 imposed an addition to tax of up to 30% of any underpayment of tax that was attributable to a valuation overstatement. 26 U.S.C. 6659. A "valuation overstatement" existed if the taxpayer reported on his tax return either a value or an adjusted basis for property that was 150% or more of the correct valuation or adjusted basis. 26 U.S.C. 6659(c). Section 6659 was repealed by the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7721(c)(2), 103 Stat. 2399. Provisions similar to Section 6659 are now found in Section 6662, relating to substantial valuation misstatements. 26 U.S.C. 6662(b)(3) and (e) (Supp. II 1990).

[3] Section 6661 imposed an addition to tax on that portion of an underpayment that is a "substantial understatement." 26 U.S.C. 6661(a). For individual taxpayers, an understatement was substantial if it exceeded $5,000 or 10% of the tax for that taxable year. 26 U.S.C. 6661(b)(1)(A). The substantial understatement penalty could be waived if the taxpayer showed that there was reasonable cause for the understatement and that he or she acted in good faith. 26 U.S.C. 6661(c). Section 6661 was repealed by the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7721(c)(2), 103 Stat. 2399. Provisions similar to Section 6661 are now found in Section 6662. See 26 U.S.C. 6662(b)(2) and (d) (Supp. II 1990).

the court held that when, as here, assets are overvalued by more than 250% and transactions are shams lacking economic substance, the increased interest under Section 6621(c) properly is imposed (Pet. App. 27a).[4]

3. The court of appeals affirmed (Pet. App. 3a-8a). Citing *Rose* v. *Commissioner*, 868 F.2d 851, 853 (6th Cir. 1989), and *Mahoney* v. *Commissioner*, 808 F.2d 1219, 1220 (6th Cir. 1987), the court stated that, once it is determined that a transaction lacks economic substance, a secondary inquiry into whether the taxpayer was motivated by profit to participate in the transaction "is never made" (Pet. App. 3a). The court therefore held that petitioner was not entitled to a loss deduction "regardless of whether [he] was actually, honestly, and exclusively motivated by profit" (*id.* at 4a). The court sustained, as not clearly erroneous, the Tax Court's finding that petitioner was negligent for purposes of Section 6653(a) because a reasonable person who knew that Graham had a personal stake in the CCAC venture would not have committed nearly $150,000 to the program without independent investigation and independent advice (Pet. App. 5a). Rejecting petitioner's contention that Section 6659 is inapplicable to underpayments in tax that result from transactions found to lack economic substance, the court concluded that "[t]he entire artifice of the CCAC shelter was constructed on the foundation of the overvaluation of

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[4] Section 6621(c) provided for 120% of the normal interest rate on substantial underpayments of tax attributable to "tax motivated transactions." An underpayment was substantial if it exceeded $1,000 (26 U.S.C. 6621(c)(2)), and a "tax motivated transaction" was defined to include, inter alia, "any valuation overstatement (within the meaning of section 6659(c))" and "any sham or fraudulent transaction" (26 U.S.C. 6621(c)(3)(A)(i) and (v)). Section 6621(c) was repealed for tax returns due after December 31, 1989, by the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7721(b) and (d), 103 Stat. 2399, 2400.

its assets. Plainly, then, [petitioner's] underpayment was attributable to his valuation overstatement" (Pet. App. 6a). The court further concluded that petitioner's argument that the Commissioner should have waived the Section 6661 addition to tax was "unavailing" because he failed to show that he reasonably relied on Graham's advice (Pet. App. 8a). Finally, because petitioner admitted that Section 6621(c) would be applicable if either the valuation overstatement penalty or the finding that he had not acted reasonably was affirmed, the court upheld the Tax Court's determination that petitioner was liable for the increased rate of interest under Section 6621(c) (Pet. App. 8a).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or of any other court of appeals. Further review is therefore not warranted.

1. The court of appeals correctly affirmed the Tax Court's conclusion that petitioner was not entitled to a loss deduction under Section 165 of the Internal Revenue Code on his investment in a tax shelter that lacked economic substance.[5] Once it has been determined that a transaction has no economic substance other than tax benefits, the transaction is disregarded for federal tax purposes. *Knetsch* v. *United States*, 364 U.S. 361, 366 (1960). Losses arising from a transaction that lacks economic substance are therefore not allowed as deductions under Section 165. Since petitioner admitted that his CCAC transactions lacked economic substance, the court was not required to conduct a further inquiry into

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[5] Under Section 165, an individual is allowed "a deduction [for] any loss sustained during the taxable year and not compensated for by insurance or otherwise," if incurred in "[a] transaction entered into for profit." 26 U.S.C. 165(a) and (c)(2).

whether he was motivated by profit to participate in the venture (Pet. App. 3a). That conclusion comports with the decisions of other courts of appeals that losses arising from a transaction that lacks economic substance are not allowed as deductions under Section 165, regardless of the taxpayer's purported profit motive. See *Shriver* v. *Commissioner*, 899 F.2d 724, 727 (8th Cir. 1990); *Dewees* v. *Commissioner*, 870 F.2d 21, 29 (1st Cir. 1989); *Kirchman* v. *Commissioner*, 862 F.2d 1486, 1493 (11th Cir. 1989).

Petitioner errs in contending (Pet. 9-10) that the decision in this case conflicts with the decisions of the Second Circuit in *Jacobson* v. *Commissioner*, 915 F.2d 832 (1990), and the Tenth Circuit in *Miller* v. *Commissioner*, 836 F.2d 1274 (1988). Neither of those cases involved a situation where, as here, the taxpayer admitted that the subject transactions lacked economic substance. Nor do those cases hold that deductions from transactions that lack economic substance are allowable if the taxpayer had a profit motive. In *Jacobson*, the question was whether the Tax Court correctly determined that the transaction at issue was "devoid of economic substance" (915 F.2d at 837). The Second Circuit held in that case that the Tax Court could not base its conclusion that the film venture lacked economic substance solely on its subjective conclusion that the film was so bad that it could never realize a profit (*id.* at 839). In *Miller*, the Commissioner disallowed losses arising from commodities straddles solely on the ground that the transactions were not entered into primarily for profit (836 F.2d at 1277), and the Tenth Circuit addressed only that issue. There is thus no authority for petitioner's claim (Pet. 9) that the court of appeals should have applied a "facts and circumstances" test to determine his profit motive.

Since his transactions lacked economic substance, his purported profit motive was irrelevant.[6]

2. The court of appeals correctly affirmed (Pet. App. 5a, 7a-8a) the Tax Court's determinations (*id.* at 24a, 26a-27a) that petitioner was liable for the additions to tax for negligence under Section 6653(a) and a substantial understatement under Section 6661, as well as the increased rate of interest on a substantial underpayment of tax attributable to a tax-motivated transaction under Section 6621(c).

For purposes of Section 6653(a), negligence is a lack of due care or the failure to do what a reasonably prudent person would do under the circumstances. *Neeley* v. *United States*, 775 F.2d 1092, 1095 (9th Cir. 1985). The Commissioner has discretion to waive the substantial understatement penalty "on a showing by the taxpayer that there was reasonable cause for the understatement * * * and that the taxpayer acted in good faith." 26 U.S.C. 6661(c). See *Heasley* v. *Commissioner*, 902 F.2d 380, 384 (5th Cir. 1990); *Mailman* v. *Commissioner*, 91 T.C. 1079, 1082-1084 (1988); Treas. Reg. § 1.6661-6(b). Petitioner contends (Pet. 12, 16, 17) that he should not be liable for these penalties because he reasonably relied on the advice of Graham, the promoter of the CCAC tax shelter. Those contentions are without merit.

The Tax Court correctly found that petitioner entered into his CCAC transactions with "no profit motive other than for the tax benefits" (Pet. App. 22a). No reasonable person interested in making an investment for profit would commit $150,000 solely on the advice of the promoter of a tax shelter without even a minimal investiga-

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[6] Even if petitioner's profit motive were relevant, the Tax Court found that petitioner "did not have an actual and honest objective of making a profit, but entered into the transactions for the sole purpose of obtaining income tax benefits" (Pet. App. 22a). That fact-bound conclusion does not warrant further review.

tion into the venture or into the promoter's knowledge of, or credentials in, the relevant industry (*id.* at 5a, 24a-25a). Moreover, petitioner made no attempt to verify the promoter's tax advice with an independent and qualified tax advisor or to determine whether Graham had any knowledge in investment or tax matters (*id.* at 20a).

Petitioner is mistaken in asserting (Pet. 15-16) that the decision of the court of appeals with respect to the Section 6661 penalty is contrary to the decision of the Fifth Circuit in *Heasley* and the decision of the Ninth Circuit in *Vorsheck* v. *Commissioner*, 933 F.2d 757, cert. denied, 112 S. Ct. 591 (1991). The taxpayers in those cases, unlike petitioner, obtained independent advice as to the tax consequences of their transactions. The taxpayers in *Heasley* read the prospectus for the venture and discussed the program in detail with both the promoter and an independent accountant before deciding to invest. 902 F.2d at 381. The taxpayers in *Heasley* also obtained advice from an outside accountant as to how to report the transaction on their tax returns and monitored the venture. 902 F.2d at 381, 384. Similarly, in *Vorsheck*, the taxpayers relied "upon the advice of their trusted tax advisor" (933 F.2d at 759). By contrast, as the court of appeals observed in the present case, petitioner "sought [no] independent professional advice on the validity and viability of the investments," and his asserted reliance on Graham cannot "be viewed as reasonable, since Graham was not a disinterested source" (Pet. App. 6a).[7]

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[7] Petitioner errs in contending (Pet. 12) that the decision in this case conflicts with this Court's decision in *United States* v. *Boyle*, 469 U.S. 241 (1985). In considering whether a taxpayer had reasonable cause for failing timely to file his tax return, the Court stated in *Boyle* that it is reasonable for a taxpayer to rely on the advice of an accountant or attorney. *Id.* at 251. The decision in *Boyle* in no way suggests that a taxpayer may be excused from

Even if petitioner's contention of reasonable reliance were accepted, it would not relieve him of liability for the increased interest rate under Section 6621(c). The critical inquiry under Section 6621(c) is whether an underpayment is "attributable to tax motivated transactions"; if so, the increased rate "shall" be imposed. 26 U.S.C. 6621(c)(1). A "tax motivated transaction" includes a valuation overstatement as defined in Section 6659 (26 U.S.C. 6621(c)(3)(A)(i)) and a sham transaction lacking economic substance (26 U.S.C. 6621(c)(3)(A)(v)). See *Kennedy* v. *Commissioner*, 876 F.2d 1251, 1256 (6th Cir. 1989); *Skeen* v. *Commissioner*, 864 F.2d 93, 96 (9th Cir. 1989)). Unlike Sections 6653 and 6661, and contrary to petitioner's assertion (Pet. 17-18), there is no provision in Section 6621(c) for avoiding the increased interest rate because of reasonableness or good faith and the Fifth Circuit did not draw such a conclusion in *Heasley*. Instead, the court found the increased interest rate inapplicable in *Heasley* because the subject transaction was profit-motivated, not tax-motivated (902 F.2d at 386), and the taxpayers' understatement was "not attributable to a valuation overstatement" (902 F.2d at 385). Neither of those circumstances is present here.

3. The court of appeals correctly held (Pet. App. 6a-7a) that imposition of the addition to tax for a valuation overstatement under Section 6659 is appropriate when, as here, deductions are disallowed on the specific ground that the transactions generating the deductions lack economic substance. See *Gilman* v. *Commissioner*, 933

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additions to tax based on reliance on the advice of the promoter of a tax shelter, as opposed to that of an independent attorney or accountant. See *Coleman* v. *Commissioner*, 60 T.C.M. (CCH) 889, 891 (1990) (requiring a taxpayer to seek tax advice independent from the promoter of a tax shelter "is not equivalent to requiring him to seek a 'second opinion,' rather, it is merely requiring him to seek 'advice' for the *first* time").

F.2d 143, 150-152 (2d Cir. 1991), cert. denied, 112 S. Ct. 871 (1992); *Massengill* v. *Commissioner*, 876 F.2d 616, 619-620 (8th Cir. 1989); *Rybak* v. *Commissioner*, 91 T.C. 524, 566-567 (1988); *Clayden* v. *Commissioner*, 90 T.C. 656, 677-678 (1988). Contrary to petitioner's contention (Pet. 13-14), this holding does not conflict with the decisions of the Fifth Circuit in *Heasley* and *Todd* v. *Commissioner*, 862 F.2d 540 (1988), or with the decision of the Ninth Circuit in *Gainer* v. *Commissioner*, 893 F.2d 225 (1990). Those cases did not involve the disallowance of deductions from a transaction that lacked economic substance. Moreover, those courts did not find that "[t]he tax benefit generated by the * * * shelter was directly dependent upon the valuation over-statement" such that the "underpayment was attributable to [the] overstatement" (Pet. App. 6a).

In both *Todd* and *Gainer*, depreciation deductions were disallowed because the property in issue had not been "placed in service" during the taxable year. In such circumstances, the Fifth Circuit held (862 F.2d at 543), and the Ninth Circuit agreed (893 F.2d at 228-229), that the taxpayers' valuation of the property had "no impact whatsoever on the amount of tax [liability] actually owed" (862 F.2d at 543). The unique facts presented in *Todd* and *Gainer* are not present here. Petitioner stipulated that he overvalued the CCAC property by more than 250% (Pet. App. 27a). Since this overvaluation resulted in improper deductions, the overvaluation penalty properly was assessed. As the court of appeals observed (*id.* at 7a), "[h]ad it not been for the valuation overstatement, [petitioner] would not have underpaid his taxes." Thus, the court's analysis is consistent with *Todd* and *Gainer*, not in conflict with them.

In *Heasley*, the Commissioner determined tax deficiencies on a number of alternative grounds, "including, among others, that petitioners did not have a profit

objective, that the EMS units were not qualifying property, *that they were not placed in service*, and that the units were overvalued." *Heasley* v. *Commissioner*, 55 T.C.M. (CCH) 1748, 1754 (1988) (emphasis added). In the Tax Court, the taxpayers conceded that they were not entitled to the investment tax credits they had claimed, without stating any specific basis for their concession. They argued that, since they had conceded the deficiencies, "it is impossible to determine the reason for any understatement" (*ibid.*) and for that reason they were not liable for the addition to tax under Section 6659. The Fifth Circuit concluded that, when a deduction or credit is disallowed in its entirety, the underpayment is not attributable to the valuation overstatement, but rather "is attributable to claiming an improper deduction or credit." 902 F.2d at 383. Although that language is broad, *Heasley* did not involve a situation in which deductions were disallowed for the specific reason that the transaction lacked economic substance. The Fifth Circuit has not directly addressed the question whether application of Section 6659 would be proper in that circumstance. It therefore cannot be said that *Heasley* conflicts with the decision in this case.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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